IN THE

Supreme Court of the United States

October Term, 1971.

No. .....

Supreme Court, U.S.
FILED
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71-9521

LAEL KOVTUN, *et al.*,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit, Judgment Affirming Judgment of the United States Tax Court.

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COMMISSIONER OF INTERNAL REVENUE,

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Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit, Judgment Affirming Judgment of the United States Tax Court.

The Petitioners respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Ninth Circuit, entered in this proceeding on September 3, 1971.

Opinion Below.

The opinion of the United States Court of Appeals for the Ninth Circuit, affirming that of the United States Tax Court, is reported at 448 F.2d 1268. The opinion of the United States Tax Court is reported at 54 T.C. 331. A copy of the opinion of the Court of Appeals is attached hereto as Appendix A; the opinion of the Tax Court is attached as Appendix B.

Jurisdiction.

The judgment of the United States Court of Appeals for the Ninth Circuit was entered on September 3, 1971. On November 24, 1971, Mr. Justice Douglas signed an Order extending the time for filing this Petition for Writ of Certiorari to and including January 31, 1972. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

This case originated when the District Director of Internal Revenue mailed Notices of Deficiency to the Petitioners herein. Within ninety (90) days after the mailing of the Notices of Deficiency, Petitions were filed with the United States Tax Court for a redetermination of the deficiency. That Court had jurisdiction under 26 U.S.C. 6213.

Questions Presented for Review.

1. Was there an existing indebtedness, owed by the Lake Murray partnership to Sunset, sufficient to form the basis for the interest deduction claimed on the partnership income tax return?

2. Does the sum of $63,000.00 paid by Lake Murray, and designated as a loan fee, constitute a payment of deductible interest?

3. If the payments herein are not deductible as interest, are they deductible as ordinary and necessary business expenses of Lake Murray, under 26 U.S.C. 162?

Statutory Provisions Involved.

United States Code, Title 26:

Section 163(a)

"General Rule—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

Section 162(a)

"In General—There shall be allowed as a deduction all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ."

Statement of the Case.

Deficiencies were assessed against Lael Kovtun and fifteen other taxpayers for the calendar year 1963. There were few or no factual controversies in this case. A great deal of the record before the Tax Court was admitted pursuant to stipulation. The controversy relates to the significance of some of the agreed facts, and the ruling of law. At issue is the deductibility of $284,813.00 claimed as interest expense by the Lake Murray partnership.

In 1963, Sunset International Petroleum Corporation (Sunset) was a publicly-held corporation. Its securities were traded on the American Stock Exchange. Sunset engaged both in the development of oil and gas properties, and the development of real estate projects scattered throughout California.

Prior to August 1963, Sunset had constructed a shopping center (Navajo Shopping Center) and a medical center (Navajo Medical Center) in the San Carlos

section of San Diego. All of these properties are located at the intersection of Navajo and Lake Murray Boulevards in San Diego. Sunset owned undeveloped real estate across the street from the Navajo Shopping Center.

S.C. Investments, Ltd. (S.C.) was a limited partnership formed in August of 1963. Its purpose was to purchase, develop, and operate Sunset's undeveloped property mentioned above. Negotiations with Sunset for purchase of the undeveloped property began in early 1963 through Marvin Strin, an accountant. Rough grading of the property had taken place and approximately $140,000.00 had been spent by Sunset prior to August 1963 on plans and grading. The initial development plans called for a senior citizens' project with about 300 units.

The accounting firm of Strin, Silver and Pecora was the general partner of S.C. Thirty-nine (39) individuals or entities invested as limited partners; the general partner invested $1,000.00, the limited partners, $600,000.00. The partners in S.C. sought to invest their money in a real estate venture and at the same time they wished to limit their personal liability. Some of the limited partners of S.C. were also investors in the Navajo Shopping Center and Navajo Medical Center, and the general partner of S.C. participated in both of those ventures. In both the Navajo Medical Center and Navajo Shopping Center, Sunset had been obligated to provide the financing, and in each of those ventures, Sunset had performed its obligations.

In August of 1963, S.C. purchased the vacant property located at the intersection of Navajo and Lake Murray Boulevards, from Sunset for $625,000.00. Also in August 1963, a partnership known as Lake

Murray Apartments (Lake Murray) was formed to construct multi-family residential dwelling units on the undeveloped real property. Sunset, the general partner, was to make no cash con tribution to Lake Murray, but was to provide construction supervision. S.C. was the limited partner, and it contributed the property it had purchased from Sunset to Lake Murray, subject to encumbrances.

On August 12, 1963, Lake Murray and Sunset entered into an agreement entitled "Financing and Construction Agreement." Sunset agreed to build the anticipated residential units pursuant to plans already drawn, to begin construction by December 10, 1963, and to complete the project within a reasonable time thereafter. Sunset agreed to loan to or procure for Lake Murray the required interim construction financing in the amount of $3,150,000.00. It was estimated that the construction period would be thirteen (13) months. Sunset had the exclusive option to satisfy its obligation to lend the required sum by securing the loan, in total or in part, from a financial institution or institutions selected by Sunset. The Agreement provided that Lake Murrary would pay to Sunset interest on said interim financing in the amount of $221,812.50 on or before December 1, 1963, which sum was in fact paid during 1963, and that such sum would be the full amount of interest to be paid by Lake Murray on the interim financing.

The Financing and Construction Agreement also provided that Lake Murray would pay to Sunset a "loan fee" in the sum of $63,000.00 on or before December 1, 1963, which sum was in fact paid during 1963. Sunset also had the obligation under the Financing and Construction Agreement to loan to Lake Murray the

permanent financing of $3,150,000.00 under the terms set forth in the Agreement. Sunset had the exclusive right to fulfill this obligation by obtaining permanent financing in part or in full from third party financial institutions.

The general partner of S.C. determined that it was advisable to obtain all of the money necessary to fund the investment from the investors at one time rather than be obligated to go back to the investors for additional money at some later time. In order to fix the amount of the necessary investment, the general partner of S.C. attempted to and was able to bind Sunset through the Financing and Construction Agreement to fix the terms for both the interim and permanent financing for the entire project. Sunset therefore had the entire risk of changes in the money market.

In the Navajo Medical Center project, commenced in the year 1962, Sunset was to provide the interim financing for the project, or to procure financing elsewhere. Sunset attempted to procure interim financing elsewhere. Sunset attempted to procure interim financing elsewhere but was unable to do so, so it provided the interim financing itself.

The balance sheet of Sunset, as set forth in its Annual Report for the fiscal year ended August 31, 1963, shows that Sunset had cash in excess of $4,000,000, current assets in excess of $27,000,000; and stockholders' equity in excess of $22,000,000. In addition there were extensive oil and gas reserves not reflected in the balance sheet (per footnote). Sunset's net income for the fiscal year 1963 exceeded $4,000,000. Sunset was also well established in the real estate business as was evidenced by the fourteen (14) pages

describing Sunset's activity in the real estate business in its Annual Report. The Lake Murray project was even described in that Report. The Report also stated that Sunset had enjoyed a compounded annual earnings growth rate of forty-five percent (45%) since fiscal 1960.

With regard to the development of the Lake Murray project itself, the grading continued during 1963 and 1964. Pursuant to its obligations under the Financing and Construction Agreement, Sunset expended the sum of $143,734.00 on construction costs on the Lake Murray project through December 31, 1963, $237,209.00 during calendar year 1964, and $33,758.00 during calendar year 1965.

The obligation of Sunset under the Financing and Construction Agreement was set forth in the books and records of Sunset as of December 31, 1963, by reflecting a liability to Lake Murray under the heading "Construction Loan Payable" in the amount of $3,160,000, showing an asset entitled "Construction Funds Available" in the amount of $3,016,266, and showing an asset for the difference of $143,734, under the title "Construction in Progress" [Ex. 38; Rep. Tr. 30, 31].

Lake Murray reflected its obligation to Sunset on its Federal Income Tax Return for the calendar year 1963 by showing a Note payable in less than one year in the amount of $3,160,000; the corresponding assets were construction funds available of $3,016,266 and buildings in progress of $143,734.

The original contractual obligations required Sunset to begin construction no later than December 10, 1963, and to proceed with reasonable speed. Sunset was unable, due to lack of funds, to proceed with the de-

velopment of the property to the extent anticipated during 1964. After 1963 there was a change in the corporate hierarchy at Sunset.

In 1963 and 1964, negotiations for take-out loans were entered into with San Diego Federal Savings and Loan Association. Sunset also submitted an application for financing to the Prudential Insurance Company during 1964. On August 21, 1964, the Prudential Insurance Company issued a commitment for *permanent* financing on the project of $3,400,000 at an interest rate of six and one-quarter percent (6¼%) and fee of $51,000. The commitment expired on August 18, 1966. On August 23, 1966, Prudential issued a re-commitment at six and three-quarter percent (6-¾%) which expired on August 16, 1968. After 1963 there were other unsuccessful attempts to arrange financing for the project, particularly with regard to *interim financing*. No loans were received. Sunset's financial position continued to deteriorate and by 1967, it was equitably insolvent. The apartments were not constructed.

On its partnership return for the year 1963, Lake Murrary claimed an interest deduction for $284,813 paid to Sunset. The components of the deduction were a "loan fee" of $63,000, and "prepaid interest" of $221,813. Respondent's determination of deficiency in each case increased taxable income of S.C.'s partners to reflect the adjustment to the Lake Murray Partnership return, disallowing the claimed interest deduction of $284,813.

REASONS FOR GRANTING THE WRIT.

I.

Importance of Issue.

Counsel for Petitioners have been active in the syndication of real property investments for a number of years. We submit to the Court that investors in real estate customarily seek an investment with limited risk, and a reasonably secure return on their investment. Tax considerations are normally important, and investors desire to project the tax consequences of their transaction prior to committing their funds. Such is the climate which existed when the Petitioners committed their funds in the year 1963, and such is the climate today. We respectfully submit to the Court that the lack of judicial authority resolving the issues raised herein creates a climate which has an unsettling effect on a substantial number of prospective business investments, all of which are healthy for the economy. An opinion by this Honorable Court in the present case will hopefully remove the confusion which now exists on the issue of "prepaid interest."

There is a serious legal question unresolved by this Court, or any Court of law prior to this case, to wit: Whether the "indebtedness" which serves as the basis for an interest deduction, may be a binding contractual obligation to advance money, or must be solely a transfer of a fund of money prior to the actual payment of the interest.

As a prelude to presenting this issue, it must be noted that the Government did not contend at trial, and the Courts below did not find, that the transactions at issue herein were sham transactions or of no economic substance. The transactions were in fact entered

into by all parties with the desire of achieving substantive economic benefit.

There were no issues of fact below. We believe that the holding of the United States Tax Court, adopted by the Court of Appeals, is at conflict in principal with earlier decisions of this Court, other trial and appellate courts, and rulings of the Internal Revenue Service.

II.

An Indebtedness Was Created as Required by Section 163.

Section 163 of the Internal Revenue Code of 1954 provides in part: "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

The trial Court cited as authority for its decision disallowing the claimed interest deduction only one decision, in which opinion the Court defined the term "indebtedness". The Appellate Court cited no authorities.

The classic definition of interest is an "amount which one has contracted to pay for the use of borrowed money" (*Old Colony R. Co. v. Commissioner,* 284 U.S. 552), and as "compensation for the use or forbearance of money" (*Deputy v. DuPont,* 308 U.S. 488). The Tax Court herein quoted *First National Co.,* 32 T.C. 798, 807, which defined the word "indebtedness" in the interest deduction statute as meaning "an existing, unconditional, and legally enforceable obligation for the payment of money". This definition is not in conflict with the position of the Petitioners.

The trial Court found that the Financing and Construction Agreement, dated August 12, 1963, required

Lake Murray to pay $221,812.50, designated as interest, and $63,000.00, designated as a loan fee, to Sunset on December 1, 1963. Sunset was obligated on December 15, 1963 to commence construction on the project and complete the project within a reasonable time thereafter, using interim financing of $3,150,000 provided or procured by Sunset. There is no evidence that the contractual obligations were neither existing, unconditional, nor legally enforceable. There were no pre-conditions to the obligations of either party under this bilateral contract.

It is clear that a cash basis taxpayer may deduct prepaid interest. *John D. Fackler*, 39 B.T.A. 395; I.T. 3740, 1945 C.B. 109. With regard to the specific issue herein, the Internal Revenue Service held in Rev. Rul. 69-188, 1969-1 C.B. 54, that: "There need not, however, be a legally enforceable indebtedness already in existence when the payment of interest is made." The interest may be paid prior to receipt of the borrowed funds, as a prerequisite to their receipt. The Ruling noted that the payment was pursuant to a "legally enforceable obligation." See also *L-R Heat Treating Co.*, 28 T.C. 894.

In an analogous situation, it has been held that a deduction would be allowed to a corporation for interest on mortgage bonds for a period prior to the issuance of the bonds. The bonds were back-dated and the interest was therefore paid for a period of time prior to the corporation receiving the monies. *Commissioner v. Philadelphia Transportation Co.* (3d Cir., 1949) 174 F.2d 255, affd. *per curiam* 338 U.S. 883. See also *Columbia River Mills* (1940) 43 B.T.A. 104, 106-107; *Oregon Pulp & Paper Co.* (1942) 47 B.T.A. 772.

In another line of cases, the Courts held that an accrual basis taxpayer may deduct accrued interest even where there is no reasonable expectation that the interest or the principal of the loan will be repaid because the debtor is contemplating or actually in bankruptcy proceedings. *Zimmerman Steel Co. v. Commissioner*, 130 F.2d 1011; *Edward L. Cohen*, 21 T.C. 855.

Contrast *Zimmerman, supra*, and this case. The indebtedness in that case existed as a paper indebtedness. The debtors were legally obligated to make the payments, but the facts demonstrated that the indebtedness and interest would in fact never be paid. Deductions were allowed for interest accrued but not paid above; in this case the interest was paid in good faith pursuant to contractual agreements requiring the lender to procure or provide the financing.

Several questions must be answered to fully understand the transaction at issue. Why did the Financing Agreement require Sunset to "provide or procure" the interim and permanent financing? The record discloses that the general partner of S.C. Investments wanted to obtain all of the money which would be necessary to fund the investment at one time, rather than be obligated to go back to the investors for additional money. The Financing Agreement fixed the terms for both the interim and permanent financing, thereby fixing the amount of the investment, and the projected return to the investors. All that was necessary was that Sunset—a major corporation—fulfill its unconditional contractual commitments.

Why didn't Sunset provide the monies that were required? The record discloses that Sunset did continue work on the project during the year 1964, at which

time it was attempting to "procure" the funds, as it was entitled to do, from a lending institution. During that year, Sunset's financial condition had worsened, and it was unable to "provide" the funds as it was contractually obligated to do. Note that in 1962, Sunset had signed an identical contract, and in fact provided the necessary funds when it was unable to procure them from a lending institution.

The Court below has breached one of the basic principles of income tax law—that tax effects must be ascertained at the end of each taxable year on the facts then known to exist. *Security Flour Mills v. Commissioner*, 321 U.S. 281, 286. The holding here apparently turns on the fact that since Sunset failed to fulfill its admitted contractual obligations in 1964 and later, no indebtedness existed since the funds were for the most part never provided or procured. The lower Courts therefore have held that the failure of Sunset to later perform its contractual obligations works to the detriment of the partners of S.C. Investments, and this judgment is made through an analysis of subsequent events. Such a holding is at variance with the principle of the individual standing of each taxable year. The interest was paid pursuant to a contractual obligation as a prerequisite to obtaining the loan. Lake Murray performed all of its obligations, and Sunset's failure to do so at a later time should not control here.

We note that the sum at issue was paid as interest by the partners of S.C. Investments, was not recovered by those persons, and in fact was a loss because of Sunset's failures. Disallowance of the interest deduction because of the failures of the third party amounts to throwing water on the drowning man.

III.

The Sum of $63,000.00 Paid by Lake Murray Constitutes a Payment of Interest.

In the proceedings below, the Commissioner supplemented his argument that there was no "indebtedness" by urging that the sum of $63,000.00 designated as a loan fee did not constitute interest. Because of the holdings below, the lower Courts did not rule on this issue. The Courts have long recognized that a payment as compensation for the use of borrowed money is interest even though it may be paid in one lump sum on or before receipt of the proceeds of the loan, and even though it may be designated as something other than interest. *Western Credit Company, Inc.*, (1962) 38 T.C. 979, aff'd. 325 F.2d 1022; *L-R Heat Treating Co.*, (1957) 28 T.C. 894, 897; *Court Holding Co.*, (1943) 2 T.C. 531; Rev.Rul. 69-582, 1969-2 C.B. 29; Rev.Rul. 69-290, 1969-1 C.B. 55; Rev.Rul. 69-188, 1969-1 C.B. 54.

The fee in question in this case was a fee for providing the interim financing. That financing would be in existence for a period of thirteen (13) months and the fee was paid to the same party as the interest payment at issue herein. There was no evidence before the Court that the payment was anything other than a payment for the use of money—namely, the interim financing.

IV.

If the Payments Herein Are Not Deductible as Interest, They Are Deductible as Ordinary and Necessary Business Expenses.

The Tax Court held that there was nothing in the Petitions to indicate that this question was in issue in the case. The record reveals that the Petitions in each and every case simply asserted that the determination of the Commissioner was incorrect in that the Commissioner had increased the distributable income to the Petitioners from various partnerships or nominee trusts. The result of the Commissioner's determination that the interest paid by Lake Murray was not deductible was reflected in adjustments to the Petitioners' returns, not through disallowance of interest expense, but rather through increase in partnership income.

This issue is clearly raised in the Petitioners' Opening Brief in the Tax Court. The Reply Brief of the Commissioner stated that the Petitioners' position was not well taken, but at no time did the Commissioner assert that the issue had not been adequately raised during trial. The Petitioners rely on the evidence produced at trial and submit that such evidence is sufficient to qualify the deduction as proper under Section 162.

Where the pertinent facts are stipulated and the question is purely one of law, an appellant may raise an issue in a tax case for the first time on appeal. *Frederick Steel Co. v. Commissioner*, (6th Cir., 1967) 375 F.2d 351, 355; *Jack Ammann Photogrammetric*

Engineers, Inc. v. Commissioner, (5th Cir., 1965) 341 F.2d 466, 467; *United States v. Merrill*, (9th Cir., 1954) 211 F.2d 297, 303.

Petitioners believe that the expenses at issue herein should properly be classified as "interest" expense and are thereby deductible under Section 163. If the expenses are not in fact "interest"; then the only other reasonable classification for said expenses is that of "commitment fees", or "carrying charges", both deductible under Section 162 of the Internal Revenue Code.

V.

Conclusion.

In *Lewis and Taylor, Inc. v. Commissioner* (9th Cir., 1971) 447 F.2d 1074, 1077, the Court noted that where a transaction has economic substance and is economically realistic, it should be recognized for tax purposes. The fact that a transaction is so arranged that the tax consequences are highly favorable to one of the parties affords the Commissioner no license to recast it into one of less advantage. The Court also stated, quoting an earlier opinion:

> "But it is equally true that the form of a contract is the considered and chosen method of expressing the substance of contractual agreements between parties and the dignity of contractual right cannot be judicially set aside simply because a tax benefit results either by design or accident. Form, absent exceptional circumstances, reflects substance."

The Court below chose to unreasonably extend the prior holdings of this Court in defining the term "indebtedness", by failing to honor good faith contractual

commitments between parties with adverse interests. Such an extension is unwarranted and is not in conformity with the prior holdings of this Court and, indeed, the prior rulings of the Commissioner. The sanctity of agreements of investors must be honored, and we respectfully ask this Honorable Court to clarify this matter of great import.

Respectfully submitted,

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By BRUCE I. HOCHMAN,
Attorneys for Petitioners.

APPENDIX A.

Opinion of the Court of Appeals for the Ninth Circuit.

United States Court of Appeals, for the Ninth Circuit.

Lael Koytun, et al., *Petitioners*, vs. Commissioner of Internal Revenue, *Respondent*. No. 25,610.

[September 3, 1971].

On Petition to Review a Decision of the United States Tax Court.

Before: MERRILL and CARTER, Circuit Judges, and COPPLE, District Judge*.

PER CURIAM:

The sixteen petitioning taxpayers in this case were all limited partners in S.C. Investments, Ltd., which was in turn a limited partner in Lake Murray Apartments. The other partner in Lake Murray was Sunset International Petroleum Corporation. On August 12, 1963, Lake Murray entered into a contract with Sunset under the terms of which Sunset was to construct residential buildings for a price of over $3,000,000. Sunset agreed to provide or procure financing for Lake Murray in meeting its obligations and Lake Murray agreed to pay Sunset a loan fee of $63,000 and prepaid interest in the sum of $221,812.50. S.C. agreed to (and did) lend Lake Murray $300,000, which sum was deposited in Sunset's project bank account on December 20 and 26, 1963. Later, after an Internal Revenue audit of Lake Murray began, Sunset made a journal entry transferring $284,812.50 to a prepaid interest account. Sun-

*Honorable William P. Copple, United States District Judge for the District of Arizona, sitting by designation.

set never did begin construction of the residential buildings and never did provide or procure the financing for Lake Murray. Sunset's financial position deteriorated until by 1967 it was equitably insolvent.

On its partnership return for the year 1963, Lake Murray claimed an interest deduction of $284,813 paid to Sunset. The Commissioner disallowed the claimed interest deduction and, accordingly, determined deficiencies in the income taxes of petitioners for that year. The Commissioner's ruling was affirmed by the Tax Court. This review followed.

The Tax Court held that the payment made to Sunset could not be regarded as prepaid interest, since no indebtedness from Lake Murray to Sunset ever came into being. For the reasons set forth in its decision, reported at 54 T.C. 331 (1970), we agree.

Affirmed.

APPENDIX B.

United States Tax Court.

Lael Kovtun, et al.,[1] Petitioners v. Commissioner of Internal Revenue, Respondent. 54 T. C. No. 29.

Docket Nos. 3390-67, 3400-67, 3401-67, 3402-67, 3403-67, 3404-67, 3405-67, 3406-67, 3407-67, 3408-67, 3409-67, 3410-67, 3411-67, 3412-67, 3424-67, 3510-67.

Filed February 24, 1970.

The petitioners in all of these consolidated cases were limited partners in S.C., a partnership that was in turn a partner in Lake Murray partnership. The latter partnership reported the payment of prepaid interest to the Sunset Corporation in its formation return. The partners in S. C. each took the ratable portion of said interest expense as a deduction in his individual return.

Held, respondent was right in disallowing said deductions for there was no existing "indebtedness" (sec. 163, I.R.C. of 1954.) owed by the Lake Murray partnership to Sunset to support the interest payment. The required indebtedness was not evidenced by a contract whereby Sunset agreed to provide and or procure financing for the Lake Murray partnership, in exchange for the partnership payment of a loan fee and prepaid interest, when the evidence shows Sunset failed to perform its obligation to provide and/or procure the financing for the partnership.

Bruce I. Hochman, for the petitioners.

Sheldon M. Sisson, for the respondent.

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[1]Cases of the following petitioners are consolidated herewith: Sawyer A. Tuller and Ethel S. Tuller, docket No. 3400-67;

(This footnote is continued on next page)

MULRONEY, *Judge:* Respondent determined deficiencies in the 1963 income tax of petitioners in these consolidated cases, as follows:

Docket Number	Petitioner	1963 Deficiency
3390–67	Lael Kovtun	$ 4,595.40
3400–67	Sawyer A. Tuller and Ethel S. Tuller	216.36
3401–67	Martin Gang and Josephine T. Gang	1,976.36
3402–67	Milton A. Rudin and Elizabeth Rudin	1,407.49
3403–67	Louis M. Brown and Hermione K. Brown	781.24
3404–67	Bruce I. Hochman and Harriet B. Hochman	10,631.38
3405–67	David Goldberg and Lillian Goldberg	220.73
3406–67	Norman R. Tyre and Margery C. Tyre	1,675.41
3407–67	Frank G. Wells and Luanne C. Wells	268.62
3408–67	Julius Kovtun	4,575.68
3409–67	Payson Wolff and Helen Wolff	618.68
3410–67	Milton Zeman and Mitzi Zeman	210.04
3411–67	Eli Boyer	245.66
3412–67	Sheldon I. Silver and Joan R. Silver	1,346.00
3424–67	Ronald R. Levy and Esther Levy	23,610.26
3510–67	Stanley L. Keller and Wilma D. Keller	610.52

These 16 petitioners (referring to husbands in joint returns) were limited partners in a partnership called S. C. Investments, Ltd.[2] The deficiencies result from

Martin Gang and Josephine T. Gang, docket No. 3401-67; Milton A. Rudin and Elizabeth Rudin, docket No. 3402-67; Louis M. Brown and Hermione K. Brown, docket No. 3403-67; Bruce I. Hochman and Harriet B. Hochman, docket No. 3404-67; David Goldberg and Lillian Goldberg, docket No. 3405-67; Norman R. Tyre and Margery C. Tyre, docket No. 3406-67; Frank G. Wells and Luanne C. Wells, docket No. 3407-67; Julius Kovtun, docket No. 2408-67; Payson Wolff and Helen Wolff, docket No. 3409-67; Milton Zeman and Mitzi Zeman, docket No. 3410-67; Eli Boyer, docket No. 3411-67; Sheldon I. Silver and Joan R. Silver, docket No. 3412-67; Ronald R. Levy and Esther Levy, docket No. 3424-67 and Stanley L. Keller and Wilma D. Keller, docket No. 3510-67.

[2] There were 39 partners in S. C. Investments, Ltd. and we are told the returns of the remaining 23 partners are with the Appellate staff in a protest stage.

respondent's adjustment that disallowed $284,813 claimed by the partnership to be interest expense. This adjustment resulted in respondent's disallowance of the individual partner's ratable portion of the interest expense that had been reported on the partnership information return.

FINDINGS OF FACT

Some of the facts have been stipulated and they will be found accordingly. All of the petitioners named above in these consolidated cases resided in California at the time the petitions were filed. They all filed their income tax returns for 1963 with the district director of internal revenue at Los Angeles, California.

In 1963 Sunset International Petroleum Corporation (Sunset) was a publicly-held corporation. Its securities were traded on the American Stock Exchange. Sunset engaged both in the development of oil and gas properties and the development of real estate projects. Sunset's real estate ventures were scattered throughout California and located in areas such as San Francisco, Marin County, Los Angeles, La Jolla, San Diego and Beverly Hills.

Sunset owned land in the San Carlos section of San Diego, California. Prior to August 1963, Sunset had constructed a shopping center (Navajo Shopping Center) and a medical center (Navajo Medical Center) in this area. All of the properties are located at the intersection of Navajo and Lake Murray Boulevards in San Diego. Sunset owned undeveloped real estate across the street from the Navajo Shopping Center. Negotiations with Sunset about the purchase of the undeveloped property at Navajo and Lake Murray Boulevards began in early 1963 by Marvin Strin, an accountant. Rough

grading of the property had taken place prior to August 1963. Approximately $140,000 had been spent by Sunset prior to August 1963 on plans and rough grading. The initial development plans called for a senior citizens' project with about 300 units.

S. C. Investments, Ltd. (S.C.) was a limited partnership. It was formed in Auguest 1963. Its purpose was to purchase, develop and operate Sunset's undeveloped property mentioned above. The accounting firm of Strin, Silver and Pecora was the general partner of S. C. Investments, Ltd. Thirty-nine individuals or entities acting as limited partners made investments in S.C. totalling $600,000. The general partner invested $1,000. Each limited partner's contribution was to be paid: 50 percent upon execution of the partnership agreement and 50 percent by December 1, 1963. Some of the limited partners of S.C. were also investors in the Navajo Medical Center.

Around August 12, 1963 S. C. purchased the vacant property located at the intersection of Navajo and Lake Murray Boulevards from Sunset for $625,000. $175,000 was paid on the purchase price and $126,000 was prepaid as interest on the encumbrance of $450,000.

Also in August 1963, a partnership known as Lake Murray Apartments (Lake Murray) was formed. It was composed of Sunset as the general partner and S. C. as the limited partner.

Lake Murray was formed to construct multi-family residential dwelling units on the undeveloped real

property located at Navajo and Lake Murray Boulevards.

Sunset, as the general partner, was to make no cash contribution to Lake Murray. It was to provide construction supervision.

S. C. contributed subject to encumbrances the property it had purchased from Sunset to the Lake Murray partnership.

On August 12, 1963 Sunset and Lake Murray entered into a "Financing Construction Agreement" which provided:

> "THIS AGREEMENT, made this 12th day of August, 1963, by and between SUNSET INTERNATIONAL PETROLEUM CORPORATION, a Delaware corporation, (hereinafter called "Sunset") and LAKE MURRAY APARTMENTS, a limited partnership, (hereinafter called "Murray").
>
> WITNESSETH:
>
> WHEREAS, as Murray desires to build certain multi-family residential buildings and related improvements and facilities on that certain unimproved real property situated in the County of San Diego, State of California, more particularly described in Exhibit "A" attached hereto, hereinafter referred to as "said real property"; and
>
> WHEREAS, Murray desires to contract with Sunset and Sunset desires to contract with Buyer for the construction on said real property of said multi-family residential buildings and related improvements and facilities, hereinafter referred to collectively as "said improvements";

NOW, THEREFORE, the parties agree as follows:

1. CONSTRUCTION OF IMPROVEMENTS:

(a) Sunset shall construct on said real property all of said improvements for Murray substantially in accordance with certain preliminary plans for said improvements. Said preliminary plans have been read and approved by Murray.

(b) In consideration for the construction of said improvements pursuant to said plans, Murray agrees to pay to Sunset the sum of Three Million One Hundred Sixty Thousand Dollars ($3,160,000.00) plus interim construction loan fees, charges, and prepaid interest, as provided for in Section 2 hereof.

2. INTERIM FINANCING:

(a) Sunset agrees to provide and/or procure for Murray the required interim construction financing in the amount of Three Million One Hundred Fifty Thousand Dollars ($3,150,000.00) during the construction period of said multi-family residential buildings and improvemnets until such time as the permanent financing hereinafter provided for is consummated.

(b) Said interim financing may be provided in all or in part by Sunset and/or in all or in part through financing from a financial institution or institutions selected by Sunset.

(c) In consideration of the obtaining and/or providing of said interim financing, Murray agrees to pay to Sunset a loan fee in the amount of

Sixty Three Thousand Dollars ($63,000.00), said sum to be paid to Sunset by Murray on or before December 1, 1963.

(d) Murray further agrees to pay to Sunset as interest on said interim financing the sum of Two Hundred Twenty One Thousand Eight Hundred Twelve Dollars and Fifty Cents ($221,812.50), said interest to be prepaid in full to Sunset by Murray on or before December 1, 1963. Said interest on said interim financing is based upon six per cent (6%) per annum on said total interim financing, for an estimated construction time of approximately thirteen (13) months.

(e) Said interim financing shall be in addition to that certain Three Hundred Thousand Dollar ($300,000.00) loan being obtained by Murray from S. C. INVESTMENTS, LTD., a limited partnership, pursuant to a loan agreement being executed simultaneously herewith.

(f) Said interest and said interim financing loan fee shall not be adjusted in any way as a result of Sunset's being able by the use of its financial credit to obtain all or a portion of said interim financing at a rate of interest below said rate of interest of six and one-half per cent (6 1/2%) per annum, or for a time in excess of said estimated time of construction of approximately eight (8) months or at a loan fee below the basis of said fee set forth above.

3. PERMANENT FINANCING.

(a) Sunset expressly agrees that it will procure and/or provide permanent financing in a total sum of at least Three Million One Hundred

Fifty Thousand Dollars ($3,150,000.00) upon the best terms available on said real property.

(b) Said permanent financing shall consist of a loan or loans in the aggregate principal amount of Three Million One Hundred Fifty Thousand Dollars ($3,150,000.00) secured by a trust deed or trust deeds on said real property.

(c) Said permanent financing shall be provided directly in all or in part by Sunset and/or procured by Sunset in all or in part from a financial institutions, said permanent financing shall

(d) Said permanent financing shall be upon such terms and conditions as Sunset shall designate except as follows:

(1) Said permanent financing shall be over a period of not less than twenty-five (25) years, providing for equal payments covering interest and amortization of principal.

(2) Said permanent financing or portion thereof, obtained by Sunset from financial institutions or other parties shall provide for the usual and prevailing prepayment penalty and other customary clauses required by such financial institution or institutions making said loan or loans, or if such loan or loans are made by other parties not financial institutions, said permanent financing shall provide for the usual and prevailing prepayment penalty and other customary clauses required by financial institutions in making loans of a similar type and nature.

(3) The average interest rate on all of said financing shall not exceed six and one-half per cent (6½%) per annum on the aggregate principal balance due.

(4) To the extent that Sunset directly provides all or a portion of said financing, by holding all or a portion of said loan or loans, there shall be no prepayment penalty payable to Sunset by Murray.

(5) Said permanent financing shall be prior in right and additional in amount to said Deed of Trust in the amount of Four Hundred Fifty Thousand Dollars ($450,000.00) covering said real property executed by S. C. INVESTMENTS, LTD., a limited partnership, in favor of Sunset as beneficiary.

(6) Said permanent financing shall be in addition to that certain Three Hundred Thousand Dollar ($300,000.00) unsecured loan being obtained by Murray from S. C. INVESTMENTS, LTD., a limited partnership, pursuant to a Loan Agreement being executed simultaneously herewith.

(7) Murray shall not be responsible for the payment of any permanent financing loan fees, if any, in connection with said permanent financing.

4. ADDITIONAL DOCUMENTS:

5. COMMENCEMENT OF CONSTRUCTION:

Murray and Sunset agree to execute any and all additional documents which may be reasonably required in order to carry out the terms and provisions of this Agreement.

Sunset agrees that construction of said improvements shall be commenced on or before December 10, 1963 and shall be completed within a reasonable time thereafter.

6. FORCE MAJEURE:

It is agreed that in the event Sunset is delayed in the performance of any of its obligations hereunder as a result of strikes, lockouts, wars, unavailability of material, floods, unusual weather conditions, government regulations and acts, or other causes beyond Sunset's reasonable control, then the time for the performance of any such obligation so delayed shall be extended for the period of such delay.

7. BINDING AGREEMENT:

This agreement shall be binding upon and inure to the benefit of the successors and assigns of the parties hereto.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the day and year first hereinabove written.

S. C. agreed to lend Lake Murray $300,000 for a period of 10 years with annual interest at 10 percent. On December 19, 1963, Strin, Silver and Pecora, the general partner of S. C. sent a check for $292,000 to Sunset. On December 24, 1963, Strin, Silver and Pecora sent a check for $8,000 to Sunset.

After Sunset received the $300,000 the money was deposited in Sunset's San Carlos Project bank account on December 20 and 26, 1963. The sum received was credited to the Lake Murray Apartments intercompany account on the San Carlos Project books. After the Internal Revenue Service audit of Lake Murray began Sunset made a journal entry transferring $284,812.50 from the intercompany account to the prepaid interest account.

The individuals comprising S. C. sought to invest their funds in a real estate venture. At the same time, they wished to limit their personal liability. Sunset sought to profit on the sale and subsequent development of its land. The original contractual obligations required Sunset to begin construction no later than December 10, 1963 and to proceed with reasonable speed. Sunset was unable due to lack of funds to proceed with the development of the property.

In 1963 and 1964, negotiations for take-out loans were entered into with San Diego Federal Savings and Loan Association. No loans were obtained. Sunset also submitted an application for financing to the Prudential Insurance Company during 1964. On August 21, 1964 the Prudential Insurance Company issued a commitment for permanent financing on the project. The commitment expired on August 18, 1966. On August 23, 1966 Prudential issued a recommitment. The second commitment expired on August 16, 1968 and Prudential did not make the loan. After 1963 there were other unsuccessful attempts to arrange financing for the San Carlos project. Between 1963 and 1967 no construction took place. There was some grading and new plans were drawn. The amount spent by Sunset on grading and plans in 1964 was $237,000.

After 1963 there was a change in the corporate heirarchy at Sunset. In late 1964 or early 1965 the senior citizens project was dropped and a general apartment house complex was proposed. Before the revised project started the Prudential financing commitment had expired. Sunset's financial position continued to deteriorate and by 1967 it was equitably insolvent.

On the 1963 Lake Murray Form 1065 balance sheet its accountants showed an asset of $3,016,266 called

"Construction Funds Available" and a liability of $3,160,000 called "Construction Contracts Payable." The difference, $143,734, was called an asset and labeled "Construction in Progress."

"Construction in Progress" was Sunset's accumulated cost for plans and grading incurred before the Lake Murray partnership was formed.

The information needed to prepare the Lake Murray return came from the accountants at Sunset.

On its partnership return for the year 1963 Lake Murray claimed an interest deduction of $284,813 paid to Sunset. The components of the deduction were a "loan fee" of $63,000 and "prepaid interest" of $221,812.50.

Sunset initially reported none of the $284,812.50 claimed as a deduction by Lake Murray as income. After the Internal Revenue Service commenced the audit of S. C. and Lake Murray and questioned Lake Murray's deduction of the $284,812.50, Sunset filed an Amended Return including the questioned amount as income. Sunset, however, had a net operating loss deduction available to it in excess of the amount included in income.

The apartments were not constructed. Respondent's determination of deficiency in each case increased taxable income of S. C.'s partners to reflect his adjustment to the Murray partnership return disallowing the claimed interest deduction of $284,813.

OPINION

Petitioners, who were limited partners, deducted their ratable portions of the so-called loan fee and prepaid interest shown on the partnership return in the total amount of $284,813, on their individual income tax returns for 1963 under section 163, I.R.C. of 1954.[3] That section provides, in part: "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

It is respondent's position that there was no existing indebtedness in relation to which any interest was paid in 1963. Respondent states on brief that "petitioners' right to deduct prepaid interest in 1963, provided there is an indebtedness, is not challenged."[4]

Petitioners argue that the indebtedness requirement of the statute was satisfied by the existence of a binding obligation on the part of Sunset to provide and/or procure the interim financing. They state on brief that each tax year must be considered "in the light of facts known at year end." The argument seems to be that at December 31, 1963, Sunset was unequivocally obligated to either provide or procure the interim financing of $3,150,00 in exchange for the loan fee of $63,000 and the prepaid interest in the sum of $221,812.50. And, petitioners argue, the fact that Sunset did not perform its obligation to provide and/or procure the interim financing is immaterial.

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[3] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise noted.

[4] This transaction arose before Rev. Rul. 68-643, C.B. 1968-2 76.

We said in *First National Co.*, 32 T.C. 798, 807, that the word "indebtedness" in the interest deduction statute "means an existing, unconditional, and legally enforcible obligation for the payment of money."[5]

The Financing and Construction Agreement of August 12, 1963 which was not complied with by Sunset, does not evidence a valid, unconditional indebtedness on the part of Lake Murray. The record is clear that in the year 1963 Sunset did not provide or procure any financing. Under the agreement Sunset was to begin construction of the building by December 10, 1963. It did not begin construction in 1963 and the building has never been constructed. Under the agreement Sunset was to obtain permanent financing and it has never done so.

Sunset's bookkeeping maneuvers with its entry to a prepaid interest account and its belated amended return reporting the receipt of prepaid interest income, both made after the deductions in issue were questioned by the revenue agent, are in no way persuasive—especially since Sunset had a 1963 loss greater than the reported prepaid interest income.

We agree with respondent. There was no valid existing indebtedness owed by the partnership to Sunset in the year 1963. The so-called interest payment was correctly disallowed. Our holding renders it unnecessary to consider respondent's alternative contention that the loan fee portion of the $284,813 ($63,000) would be a capital expenditure.

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[5] Although this case was reversed on appeal on another issue, the Court of Appeals for the Sixth Circuit specifically approved our definition of the term "indebtedness" in the interest deduction statute. *First National Co. v. Commissioner*, 289 F. 2d 861, 865.

Petitioners state on brief that if the payments herein are not deductible as interest they should be classified as "commitment fees" or "carrying charges" and deductible as ordinary and necessary business expenses. There is nothing in the petitions to indicate that such a question was in issue in this case nor was there evidence introduced at the time of trial with respect to an issue of ordinary and necessary business expense. In any event, there is no merit to this theory of petitioners. The record, which fails to show the existence of an indebtedness to support an interest deduction, will not sanction calling the payment an ordinary and necessary business expense.

Decisions will be entered for the respondent.